

alternative Access Networks to BT by the end of 1996 and considerable further investment is planned. Any move to allow operators to take over BT exchange lines would undermine past investments and jeopardise future plans.

47. Our conclusion, therefore, is that direct connection to the BT Access Network would adversely affect the development of competition and would not be in the interests of the UK consumer.

Comments

48. OFTEL welcomes comments on this Statement by the end of September 1996, which should be sent to :

Vince Affleck
Interconnection Manager
OFTEL
50 Ludgate Hill
London, EC4M 7JJ

Comments on this document can also be sent to OFTEL on the Internet (if they are relatively short) in the form of the web pages or by using the following e-mail address:

press.office.OFTEL@gtinet.gov.uk

Annex A: THE CURRENT LEGAL POSITION ON INDIRECT ACCESS

1. Conditions 13.1(a) and (c) - of BT's licence places an obligation on BT to connect its systems to those of any operator who runs a 'Relevant Connectable System' (RCS) when requested by that operator to do so, and to provide to such an operator the services reasonably required to enable the operator to provide services to its customers. The rules governing Relevant Connectable System status are somewhat complex, but it is sufficient to note for these purposes that all the main network operators in the UK - those classified as 'public telecommunications operators' - and also some service providers, have RCS status. It should also be noted that all the licences of the other public telecommunications operators (PTOs) themselves contain similar provisions to condition 13. The provisions of Conditions 13.1(a) and (c) - may also oblige BT to provide RCSs with indirect access to BT's customers.

2. Condition 13.1(b), in any event, places a specific requirement on BT that, in respect of so-called 'long-line PTOs' (PTOs with systems that extend over more than 50 linear km), it shall:

"...establish and maintain such Points of Connection as will enable persons running telecommunication systems connected to the [Long-line PTO's] system and persons running telecommunication systems connected to [BT's system] to exercise freedom of choice as to the extent to which Messages are conveyed by means of [BT's system] and in routing Messages so conveyed;"

In other words, customers connected to BT must be given the choice as to whether their calls are carried in whole by BT, or (by inference) in part by another long-line PTO.

3. As well as these general provisions covering indirect access, BT's licence and other PTO licences contain specific measures covering so-called 'equal access'. The indirect services described hitherto generally involve customers having to dial extra digits and/or follow additional procedures in order to use the indirect service. 'Equal access', on the other hand, as defined in the licence is parity in the number of digits dialled to access an indirectly-provided service as for the equivalent service provided by the operator to whom the customer is directly-connected. This could be achieved either by a customer dialling extra digits for each call made, for instance, 1234 for calls over the BT system, 1235 for calls over the Mercury system and 1236 for calls over the Energis system, or by customers electing to route calls over a given network for a subsequent period.

4. Condition 13A of BT's licence and its equivalents include the obligation to provide such 'equal access' in respect of competitors' trunk and international services. However, the Director General can only impose such an obligation on the licensee where he has conducted a cost-benefit analysis. There are other important qualifications to the Director General's power to direct BT to provide equal access. It should also be noted that the condition includes specific provisions for sharing of the licensee's costs between itself and the operators who are recipients of the equal access provided.

ANNEX B: MDF INTERCONNECT WITH COLOCATION RIGHTS

How an operator could build a bypass network of directly connected customers using BT's copper loop.



96 12 8328

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 20-F**ANNUAL REPORT PURSUANT TO SECTION 13
OF THE SECURITIES EXCHANGE ACT OF 1934**for the fiscal year ended **March 31, 1996**

Commission file number 1-8819

RECD S.E.C.

JUL 5 1996

FEE 022

BRITISH TELECOMMUNICATIONS public limited company

(Exact name of registrant as specified in its charter)

ENGLAND AND WALES

(Jurisdiction of incorporation or organization)

BT CENTRE, 81 NEWGATE STREET, LONDON EC1A 7AJ, ENGLAND

(Address of principal executive offices)

PROCESSED BY
116-100-3
JUL 09 1996

DISCLOSURE INC.

Securities registered or to be registered pursuant to Section 12(b) of the Act:

Title of each class

Name of each exchange
on which registered**American Depositary Shares
Ordinary shares of 25p each****New York Stock Exchange
New York Stock
Exchange***

*Not for trading, but only in connection with the registration of American Depositary Shares, pursuant to the requirements of the Securities and Exchange Commission.

Securities registered or to be registered pursuant to Section 12(g) of the Act:

None

Securities for which there is a reporting obligation pursuant to Section 15(d) of the Act:

None

Indicate the number of outstanding shares of each of the issuer's classes of capital or common stock as of the close of the period covered by the Annual Report.

6,291,457,275**1****Ordinary shares of 25p each****Special rights redeemable preference share of £1**

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months and (2) has been subject to such filing requirements for the past 90 days.

Yes ☒ No ☐

Indicate by check mark which financial statement item the registrant has elected to follow.

Item 17 ☐ Item 18 ☒

TABLE OF CONTENTS

	Page
Exchange Rates	1

PART I

Item 1	Description of Business	
	Introduction	2
	BT's services	3
	Network modernization and capital expenditure	6
	Organization and employees	8
	Strategic alliance between BT and MCI	9
	Regulation, competition and prices	10
	Relationship with HM Government	21
Item 2	Description of Property	22
Item 3	Legal Proceedings	22
Item 4	Control of Registrant	22
Item 5	Nature of Trading Market	23
Item 6	Exchange Controls and Other Limitations	
	Affecting Security Holders	24
Item 7	Taxation	26
Item 8	Selected Financial Data	29
Item 9	Management's Discussion and Analysis of	
	Financial Condition and Results of Operations	
	Introduction	32
	Results of operations	36
	Liquidity and capital resources	39
	Other matters	41

		Page
Item 10	Directors and Officers of Registrant	45
Item 11	Compensation of Directors and Officers	48
Item 12	Options to Purchase Securities from Registrant or Subsidiaries.....	50
Item 13	Interest of Management in Certain Transactions	54

PART III

Item 15	Defaults upon Senior Securities.....	54
Item 16	Changes in Securities and Changes in Security for Registered Securities.....	54

PART IV

Item 18	Financial Statements.....	54
Item 19	Financial Statements and Exhibits.....	55

Note: Items 14 and 17 have been omitted as not applicable

EXCHANGE RATES

In this Annual Report, references to "\$" are to United States ("US") dollars, references to "pounds sterling", "£", "pence" or "p" are to United Kingdom ("UK") currency and references to "fiscal" or "fiscal year" are to the financial year ended March 31 of each year (e.g., "fiscal 1996" refers to the financial year ended March 31, 1996). References to the "Company" are to British Telecommunications public limited company, and references to "BT" or the "Group" are to the Company and its subsidiaries, or any of them, as the context may require.

BT publishes its consolidated financial statements expressed in pounds sterling. Merely for the convenience of the reader, this document contains translations of certain pound sterling amounts into US dollars at specified rates. These translations should not be construed as representations that such pound sterling amounts actually represent such US dollar amounts or could be converted into US dollars at the rate indicated. Unless otherwise stated, the translations of pounds sterling into US dollars have been made at the noon buying rate in New York City for cable transfers in pounds sterling as certified for customs purposes by the Federal Reserve Bank of New York (the "Noon Buying Rate") in effect on March 31, 1996, which was \$1.53 to £1.00.

The following table sets forth, for the periods indicated, certain information concerning the exchange rates between pounds sterling and US dollars based on the Noon Buying Rate:

Fiscal year	Period end	Average(a)	High	Low
1992	1.74	1.73	1.88	1.60
1993	1.51	1.68	2.00	1.42
1994	1.49	1.50	1.59	1.46
1995	1.62	1.57	1.64	1.46
1996	1.53	1.52	1.56	1.50

(a) The average of the Noon Buying Rates in effect on the last day of each month during the relevant period.

On June 28, 1996, the Noon Buying Rate was \$1.55 to £1.00.

For information regarding the effects of currency fluctuations on the market price of the ordinary shares of 25p each in the Company (the "Ordinary Shares") and of its American Depositary Shares ("ADSs"), see "Item 5 — Nature of Trading Market". For information regarding the effects of currency fluctuations on the Group's results, see "Item 9 — Management's Discussion and Analysis", and on the conversion of dividends, see "Item 8 — Selected Financial Data — Dividends".

PART I

ITEM 1 - DESCRIPTION OF BUSINESS

Introduction

BT is one of the world's leading providers of telecommunication services. Its main services and products are local and long-distance telephone calls in the United Kingdom, the provision of telephone exchange lines to homes and businesses, international telephone calls made from and to the United Kingdom, the provision of private circuits to businesses, the supply of telecommunication equipment for customers' premises and the supply of mobile communication services and equipment to businesses and individuals. BT also offers a range of other products and services.

The Company was incorporated under the laws of England and Wales on April 1, 1984 as a public limited company wholly-owned by Her Majesty's Government of the United Kingdom ("HM Government"). In December 1984, HM Government sold just over 50% of the Ordinary Shares to the public in a worldwide offering and, in December 1991, sold a further 25.6% of the Ordinary Shares. In July 1993, HM Government sold substantially all of its remaining holding of the Company's Ordinary Shares.

The following table shows the principal components of BT's operating revenues during each of the last five fiscal years. In fiscal 1996, approximately 98% of BT's total operating revenues arose from operations in the United Kingdom.

Operating revenues	Year ended March 31,					
	1992	1993	1994	1995	1996	1996(a)
	(in millions)					
UK local and long-distance telephone calls	£ 5,111	£ 5,095	£ 5,193	£ 4,941	£ 4,882	\$7,469
Telephone exchange line rentals	2,117	2,233	2,402	2,534	2,685	4,108
International telephone calls	1,853	1,859	1,960	1,935	1,980	3,029
Private circuits	933	994	992	1,024	1,056	1,616
Customer premises equipment supply	1,251	1,025	1,003	1,041	946	1,447
Mobile communications	338	375	459	657	856	1,310
Yellow Pages directories	319	318	343	371	408	624
Other sales and services	1,415	1,343	1,323	1,390	1,633	2,499
Total operating revenues	£13,337	£13,242	£13,675	£13,893	£14,446	\$22,102

(a) Translated at \$1.53 to £1.00, the Noon Buying Rate in effect on March 31, 1996.

BT essentially operates as a unitary business, providing an integrated range of telecommunication products and services. Accordingly, BT has not, to date, published separately the net operating income for the various sources of operating revenues. Management considers that the Group's net operating income is derived predominantly from UK local and long-distance and international telephone calls, after taking account of a substantial operating deficit arising on the provision of exchange lines. The Company does, however, prepare, at the direction of the UK Director General of Telecommunications (the "Director General"), financial statements for its businesses and activities as defined by the Director General. See "Item 9 — Management's Discussion and Analysis — Introduction".

BT and MCI Communications Corporation ("MCI"), the second largest carrier of long-distance telecommunication services in the United States, have a strategic alliance operating through Concert Communications Company ("Concert"), an international joint venture company. BT has a 20% interest in MCI. See "Strategic alliance between BT and MCI".

Competition and regulatory environment

BT operates in the United Kingdom in an environment of growing competition and extensive regulation. The growing number of providers of telecommunication services is creating an increasingly competitive market for those services. The prices of services that generate a majority of the Group's operating revenues are controlled through a license granted by the UK Secretary of State for Trade and Industry (the "Secretary of State") which is enforced by the Director General, who also has broad supervisory powers and duties under the UK Telecommunications Act 1984 (the "Telecommunications Act"). This license has been amended frequently. A number of new amendments have recently been proposed, in particular in connection with price control and new rules on fair trading. See "Regulation, competition and prices — Prices — Pricing of telecommunications services from 1997" and "Regulation, competition and prices — Regulation — Fair trading in telecommunications". As BT expands its interests and activities outside the United Kingdom, regulatory regimes elsewhere in the world are becoming an increasingly important feature of its operating environment.

Strategy

BT's strategy is to develop and grow new business in the United Kingdom which BT believes is the most open and competitive telecommunications market in the world; to expand into new services such as interactive television and multimedia; and to develop further its presence overseas in chosen markets, both alone and through partnerships.

BT's services

UK telephone services

Within the United Kingdom, the Company has more than 27 million customer lines (exchange line connections), comprising approximately 20.5 million residential lines and approximately 6.8 million business lines, over which, on average, approximately 100 million UK local and long-distance telephone calls are made each day. Telephone calls comprise both voice and non-voice traffic, such as facsimile and data transmissions, and include calls to directory assistance services.

The following table shows the estimated growth rates in the volume of BT's UK local and long-distance telephone calls in each of the last five fiscal years:

BT's UK call growth	Year ended March 31,				
	1992	1993	1994	1995	1996
Estimated growth over previous year in BT's UK telephone call volume (a)	1%	0%	6%	7%	6%

(a) Growth is estimated by reference to revenue growth attributable to UK local and long-distance telephone calls, adjusted to eliminate the effect of price changes.

UK local and long-distance telephone calls accounted for approximately 34% of the Group's total operating revenues in fiscal 1996.

Call growth in recent years has resulted mainly from the increase in usage of the lines in service, stimulated partly by significant price reductions introduced since December 1993 and the growth in the UK economy.

The price structure for call charges is complex, varying with distance, duration, time of day, usage and the applicability of discount schemes. BT now charges for the exact duration of the call, subject to a minimum charge. This replaces the former unit-based charging system which operated until June 1995.

In fiscal 1996, telephone exchange line rentals accounted for approximately 19% of the Group's total operating revenues. BT's exchange line customers are generally charged a uniform quarterly rental per line, the charge for business lines being higher than for residential lines.

The following table shows, for BT's business and residential exchange lines, the number of connections at the end of each of the last five fiscal years and the respective percentage growth or decline in the number of connections from the previous year:

BT's exchange line connections	At March 31,				
	1992	1993	1994	1995	1996
	(in thousands, except percentage amounts)				
Business	5,859	5,947	6,129	6,459	6,798
Growth	1.2%	1.5%	3.1%	5.4%	5.2%
Residential	19,729	20,114	20,471	20,613	20,500
Growth (decline)	0.8%	2.0%	1.8%	0.7%	(0.5)%
Total	25,588	26,061	26,600	27,072	27,298
Growth	0.9%	1.8%	2.1%	1.8%	0.8%

Since the beginning of 1995 BT has experienced a small net reduction in residential exchange line connections as a result of the growing competition from cable television companies that offer integrated television and telephony services. See "Regulation, competition and prices — Competition — Cable television" for a discussion of the growth of cable telephony.

BT also undertakes the installation and reconnection of exchange lines. In fiscal 1996, there was an increase of approximately 3% in the number of new exchange line connections, compared with fiscal 1995. Revenues from these services are included under "Other sales and services".

International telephone calls

International telephone calls accounted for approximately 14% of the Group's total operating revenues in fiscal 1996. The greater part of BT's international telephone call traffic is generated from a limited number of routes. 73% of outgoing call volume is to 21 countries, the largest element of which, calls to the United States, accounted for 18% of outgoing call volumes in fiscal 1996. The United Kingdom is one of the world's principal telecommunication transit centers, enabling calls originating and terminating outside the United Kingdom to be routed through it. International direct dialling from BT's UK network is available to more than 230 countries and other territories, and almost all international calls originating from BT's UK network are direct dialled.

International call revenues are derived from outgoing calls made by customers in the United Kingdom and from receipts from overseas telecommunications operators for incoming calls which use BT's facilities. In turn, BT makes payments to overseas operators for the use of their facilities. The rates for payments (known as "accounting rates") are agreed bilaterally under the general auspices of the International Telecommunications Union. BT's receipts and payments are broadly in balance overall.

The following table shows the estimated growth rates in the volume of BT's international telephone calls (outgoing, incoming and transit) in each of the last five fiscal years:

BT's international call growth	Year ended March 31,				
	1992	1993	1994	1995	1996
Estimated growth over previous year in BT's international call volume (a)	4%	6%	6%	5%	9%

(a) Growth is estimated by reference to revenue growth attributable to international telephone calls, adjusted to eliminate the effect of changes in prices and in currency exchange rates.

Growth in the volume of international calls over this period has resulted primarily from the increase in the usage of the lines in service and, with the exception of fiscal 1995 and 1996, from a significantly higher level of transit traffic through the United Kingdom. The higher international call growth in fiscal 1996 resulted from strong demand for outgoing calls to continental Europe and North America. BT believes that the increased usage was partly attributable to price reductions. Call charges to the United States and Canada were reduced by 20% in February 1995 contributing to the average overall price reductions of 7% in fiscal 1996.

Historically, reductions in accounting rates have generally not kept pace with reductions in the underlying costs of providing international telecommunication services. BT is seeking lower accounting rates around the world and lower rates have been agreed with the overseas operators with which the majority of BT's international traffic is exchanged. Lower accounting rates increase BT's flexibility in pricing international telephone calls.

Volume changes for the activities described below have been estimated by adjusting revenues to eliminate the effect of price changes.

Private circuits

BT provides customers with private circuits, which are lines between fixed points reserved for the exclusive use of a customer, leased at a fixed rate irrespective of usage. BT has around 480,000 UK and international customer private circuits in service. There is continuing change from analogue to digital circuits, in part because digital circuits normally have a greater capacity and flexibility of use. Private circuit revenue volumes increased by approximately 5% in fiscal 1996. Private circuit revenues accounted for approximately 7% of the Group's total operating revenues in fiscal 1996.

Customer premises equipment supply

BT rents and sells a wide range of equipment for customer premises, from telephones for use in the home to advanced private exchange equipment for businesses. These activities accounted for approximately 7% of the Group's total operating revenues in fiscal 1996.

Mobile communications

Mobile communication services and products supplied by BT mainly comprise cellular telephony, radiopaging and voice messaging and accounted for approximately 6% of the Group's total operating revenues in fiscal 1996. Cellular telephony has continued to grow at a faster pace than other sectors of the telecommunications industry in the United Kingdom and internationally.

The Company owns 60% of Cellnet, one of two cellular telephone network operators licensed by HM Government. The other licensed operator is Vodafone. In addition, HM Government has licensed two operators of personal communications networks ("PCNs"), Orange, and Mercury One-2-One. The cellular and PCN operators sell their mobile services direct to customers as well as through independent service providers, including BT. As a result of the launch and rapid growth of PCN services, the market for mobile telephone services has become more competitive, with consequent pressure on prices.

Cellnet now reaches nearly all of the United Kingdom providing comprehensive coverage of all major populated areas. Cellnet launched a new digital system in 1994 using the global GSM digital cellular standard, which operates alongside Cellnet's current analogue system. The new digital service provides a new technology platform for advanced high quality service offerings, including international roaming to 35 countries and across more than 50 networks to date, with the prospect of allowing much larger customer bases to be supported.

In autumn 1992, Cellnet introduced a pricing package for customers who are infrequent users of cellular telephones, which has contributed to a marked acceleration of growth in this sector. Cellnet has more recently reduced a number of its charges.

The following table shows the number of telephones subscribed to Cellnet's network at the end of each of the last five fiscal years:

Cellnet (Cellular telephones in the United Kingdom)	Year ended March 31,				
	1992	1993	1994	1995	1996
	(in thousands)				
Analogue — low usage tariffs	-	107	331	935	1,463
Analogue — high usage tariffs	547	551	688	765	573
Digital GSM	-	-	-	34	353
Total	547	658	1,019	1,734	2,389

As the number of users of the new digital GSM system increase, there is a decrease in the number of users of the analogue high usage tariff as users migrate from the analogue to the digital system.

BT estimates that the total number of telephones connected to the two UK cellular networks at March 31, 1996 was 4.8 million, up from 3.6 million at March 31, 1995. In addition, Orange had around 480,000 customers and Mercury One-2-One had around 440,000 customers at March 31, 1996.

Yellow Pages

Yellow Pages is responsible for a portfolio of products including a series of regional classified information directories in the United Kingdom to meet both consumer and business needs. Sales of its products accounted for approximately 3% of the Group's total operating revenues in fiscal 1996. Revenue from volume growth of advertisements published by Yellow Pages increased by 4% in fiscal 1996 compared with fiscal 1995.

Other sales and services

Other sales and services, which accounted for approximately 11% of the Group's total operating revenues in fiscal 1996, include carrier telecommunication services, charges for exchange line connections and various other activities.

Carrier telecommunication services — whereby existing telecommunications operators and new entrants to the UK telecommunications market can utilize BT's network through interconnection to it.

Managed network services including overseas sales — local access to, and provision of, value-added communications services used in the transmission of computer data. Concert, BT's joint venture with MCI, provides an extensive range of value-added voice and data communications services. These services are available to customers in more than 100 countries.

Outsourcing services — telecommunication outsourcing services for the management of complex international communication needs of organizations for voice and data.

Other services — BT also provides toll-free services; visual communication services, including the distribution of television material for broadcasting organizations, video-conferencing and closed circuit television; and integrated business systems and services offered through a division of BT, Syntegra. BT launched a mass market dial-up Internet service for residential and small business customers, as well as users new to the Internet, on March 29, 1996.

Expansion overseas

BT continues to pursue opportunities to enter into joint ventures and strategic alliances around the world.

BT has formed an alliance with MCI in the United States which principally involved the creation of Concert to offer global networking solutions to a range of major companies. See "Strategic alliance between BT and MCI".

In Germany, BT and VIAG have formed a joint venture company, VIAG INTERKOM, to offer value-added managed data network and corporate voice services to German businesses nationally and internationally. In February 1996 BT and VIAG signed a letter of intent with RWE, a German industrial group, to offer telecommunications services to business and residential customers in Germany.

In Spain, BT has a joint venture with Banco Santander to meet customer requirements for managed data communications in the Spanish market. BT also holds a minority shareholding in Airtel, which is building a digital cellular network in Spain. In Sweden, an alliance has been established with Tele Danmark and Telenor of Norway to form a telecommunications operator, Telenordia. In Italy, BT has entered into a joint venture, Albacom, with Banca Nazionale del Lavoro to offer value-added data network and corporate voice services to Italian businesses. Mediaset, a major television company in Italy, has taken an equity interest in Albacom. In addition, BT has taken a small equity interest in Mediaset.

BT has acquired 25% of Clear Communications Limited, New Zealand's second largest telecommunications company. MCI also has a 25% stake. There are also partnerships in many countries in the Asia Pacific region to supplement distribution agreements for Concert services in major business centres worldwide. In addition, BT is continuing its program of expanding its overseas network and providing network-based services.

To strengthen Syntegra's position in Europe, BT has acquired systems integration companies in France and the Netherlands.

Network modernization and capital expenditure

BT has been engaged in an extensive program of modernizing, improving and expanding its telecommunication network. BT continues to install local digital telephone exchanges to replace semi-electronic exchanges. The replacement of electro-mechanical exchanges was completed in June 1995. The installation of digital switching and

associated transmission equipment throughout BT's UK long-distance network was completed in fiscal 1991. BT is also continuing to install optical fiber cable in the network.

BT's digital network has improved call quality for customers and provided management with more flexibility and control, and has led to reductions in maintenance manhours. It also makes possible the integration of voice, data and other services into a single Integrated Services Digital Network ("ISDN"), which is being offered to customers served by digital exchanges.

Capital expenditure

BT's capital expenditure over the last five fiscal years is shown in the table below:

BT's capital expenditure	Year ended March 31,					1996(a)
	1992	1993	1994	1995	1996	
	(in millions)					
Plant and equipment						
Transmission	£1,173	£ 835	£ 896	£1,060	£1,114	\$1,705
Telephone exchanges	722	545	493	605	566	866
Other network equipment	281	296	335	378	491	751
Computers and office equipment	170	152	219	343	333	510
Motor vehicles and other	131	272	153	214	195	298
Property	54	66	51	75	87	133
Increase (decrease) in engineering stores	(85)	(11)	24	(4)	(15)	(23)
Total expenditure on property, plant and equipment	£2,446	£2,155	£2,171	£2,671	£2,771	\$4,240

(a) Translated at \$1.53 to £1.00, the Noon Buying Rate in effect on March 31, 1996.

BT's investment in modernization continues to be a major priority. The Group's total expenditure on property, plant and equipment increased by £100 million or 3.7% in fiscal 1996. Expenditure on transmission equipment, telephone exchange and other network equipment accounted for 78% of the total capital expenditure. In fiscal 1996 BT concentrated on investments in digital exchanges to provide advanced services, in Cellnet's digital cellular system and in computers for improved customer services. BT expects capital expenditure in fiscal 1997 to be at a slightly higher level than that of fiscal 1996. See "Item 9 — Management's Discussion and Analysis — Liquidity and capital resources — Capital expenditure".

UK network

Under the program of local exchange modernization, approximately 88% of the customer lines in service are now served by digital exchanges. In the United Kingdom, BT's customer lines are now connected to digital or semi-electronic exchanges, enabling the vast majority of customers to access a range of advanced network services, including call forwarding and reminder calls. In fiscal 1996 the "call minder" service was launched, providing call answering and routing services. The following table shows the percentage of customer lines in service served by type of exchange and the percentage availability of itemized billing (made possible by exchange modernization and now available to all customers) at the end of each of the last five fiscal years:

Network modernization	At March 31,				
	1992	1993	1994	1995	1996
Customer lines served by type of telephone exchange					
Digital	54.6%	64.0%	74.9%	82.7%	87.7%
Semi-electronic	35.0	31.9	24.6	17.2	12.3
Electro-mechanical	10.4	4.1	0.5	0.1	—
Total	100.0%	100.0%	100.0%	100.0%	100.0%
Itemized billing availability	80.7%	88.6%	96.5%	99.2%	100.0%

Optical fiber accounts for approximately 86% of the UK long-distance network's current capacity. In the junction network (connecting local exchanges), optical fiber generally continues to be the most cost-effective method of meeting new capacity requirements. BT also continues to improve and modernize its local network of cables. While only a very small proportion of the local network's capacity is currently provided by optical fiber cable, where there is sufficient demand and BT judges that it will be economic to do so, optical fiber will be deployed to connect customers' equipment to the local exchange.

The following table shows the number of kilometers of optical fiber in BT's network at the end of each of the last five fiscal years:

Optical fiber	At March 31,				
	1992	1993	1994	1995	1996
			(in thousands)		
Fiber – kilometers in the network	2,045	2,337	2,577	2,782	3,043

International networks

BT continues to invest in its international digital cable and satellite network infrastructure to support a growing range of advanced communication services between the United Kingdom and the rest of the world. Optical fiber cable links are now available from the United Kingdom to many destinations, including continental Europe, North America and Japan. BT has investments in a number of international consortia which provide and own satellite communication facilities. All of BT's international telephone calls are switched through digital international exchanges in the United Kingdom. BT is investing in switching and transmission equipment for the provision of international virtual network services.

Research and development

Recognizing the pace of technological change in the telecommunications industry, BT undertakes a wide range of research and development activities. The major part of BT's expenditure on research and development, which in fiscal 1996 totalled £282 million, is directed towards the development of new and improved networks and services for customers. Increasingly, resources are being devoted to software systems to provide better managed and more intelligent networks and network services, but work also continues on optical fiber systems, speech and image processing, and mobile applications.

During fiscal 1995, BT successfully completed trials to assess the technical feasibility of offering customers entertainment and information services over the telephone network to their television set. These technical trials included interactive multimedia services, such as "video-on-demand" television services. A market trial was launched in fiscal 1996 after which the results will be analysed and a decision will be taken about the nature of the service to be introduced.

Organization and employees

Organization

BT is organized into three customer-facing operating divisions, Global Communications, National Business Communications and Personal Communications; the Networks and Systems operating division; and a number of other support units.

Global Communications serves business customers who require telecommunication services around the world. It is also responsible for BT's relationship with Concert, BT's joint venture with MCL Business customers whose telecommunications requirements fall mainly within the United Kingdom are served by National Business Communications. Personal Communications provide the primary interface between BT and its residential customers. It also has responsibility for mobile communications in the United Kingdom and internationally, and for BT's public payphones. Networks and Systems is responsible for the design, operation, maintenance and development of BT's networks and technology. It is also responsible for BT's research and development facility. Other support units provide specialised services.

Employees

The following table shows the total number of BT's employees at the end of each of the last five fiscal years:

BT's employees	At March 31,				
	1992	1993	1994	1995	1996
Total employees	210,500	170,700	156,000	137,500	130,700

The number of BT's employees has fallen substantially over the last five fiscal years as a result of improvements in operating efficiency, a reduction in layers of management and in directory assistance work, the contracting-out of certain services, and business disposals. In line with its continuing drive to improve productivity BT expects to make further reductions in fiscal 1997. See "Item 9 — Management's Discussion and Analysis — Results of operations — Operating expenses".

An estimated 83% of the Company's employees belong to two main trade unions recognized by the Company. The pattern of industrial relations in the last few years has been generally stable. The reduction in the number of employees has so far been implemented on a voluntary basis and without significant disruption to BT or its customers. BT will have completed the last of the company-wide voluntary workforce reduction programs by the end of September 1996.

Most BT employees are members of the BT Pension Scheme, which is controlled by trustees who are Company or union nominees.

Strategic alliance between BT and MCI

Introduction

BT and MCI have implemented a strategic alliance which principally involved: the creation of Concert in July 1994 which enabled BT and MCI to combine their international enhanced voice and data services; and the investment by BT of approximately \$4.3 billion (£2.8 billion) to acquire a 20% interest in MCI, the second largest carrier of long-distance telecommunication services in the United States.

BT believes that the alliance with MCI is helping BT to achieve its international strategy. It brings together the two companies' technical and marketing skills, which facilitate the provision of improved services. The alliance also provides BT with a significantly enhanced position in North America through its interests in MCI and Concert.

This section includes a description of the business of MCI, parts of which have been extracted from MCI's annual report on Form 10-K for the year ended December 31, 1995 (the "1995 MCI 10-K").

Business of Concert

Concert provides BT and MCI with a portfolio of globally managed voice and data related products and services. These services include packet switching, frame relay, flexible bandwidth and virtual voice networks and are provided across a global platform (transmission, switching and other facilities). Concert's portfolio of products and services is targeted at meeting the international telecommunications requirements of the world's major companies.

Concert is held 75.1% by BT and 24.9% by MCI. BT has appointed four of the seven directors of Concert. However, the consent of MCI is required for all significant matters, including the adoption of the annual business plan of Concert. MCI and BT have rights of first refusal over each other's shares in Concert. BT and MCI have agreed not to compete with Concert in the provision of enhanced and value-added telecommunication services or international outsourcing services.

BT and MCI have announced that their separate Internet networks will be combined by Concert to provide a high-speed, global Internet network.

Investment by BT in MCI

BT holds approximately 20% of MCI's share capital. BT has the right to invest in further common stock to maintain its interest at 20% in the event of further common stock being issued by MCI. In view of the restriction on the level of stock that can be owned of record or voted by non-US citizens in US telecommunications companies (currently 25% although the FCC has granted a waiver permitting foreign ownership of up to 28% of the stock of MCI), see "Regulation, competition and prices — Regulation — Overseas regulation", MCI has agreed that it will not, save in certain

circumstances, issue any common stock to non-US citizens. BT is aware that there may be existing non-US citizens who own MCI common stock but does not know the extent of such ownership. The investment agreement between BT and MCI prohibits BT from increasing its shareholding in MCI above 20% until September 30, 2004, except in certain circumstances.

On the basis of its 20% investment, BT has exercised its right to nominate three directors to the MCI board of 15 directors. Mr. Bert C. Roberts, Jr., the chairman and chief executive officer of MCI, is a director of the Company.

Description of MCI's business

MCI provides a broad range of communications services, including long-distance telecommunications services, local and wireless services and information technology services. The provision of long-distance telecommunications services is MCI's core business. MCI is the second largest nationwide carrier of long-distance telecommunications services in the United States and the third largest carrier of international long-distance telecommunications services in the world. During each of the last three years, more than 90% of MCI's operating revenues and operating income were derived from its core business.

Evolving and newly developed technology, emerging significant competition in the market for long-distance and local telecommunications services, as well as the increasing desire of customers to have most or all of their various communication needs fulfilled by one supplier, are causing companies, including MCI, which offer services primarily in one part of the communications services market, to offer, either directly or through alliances with others, new services to complement their primary service offerings.

MCI expects that this expansion into new services will continue and is likely to accelerate as a result of the enactment of the Telecommunications Act of 1996 in February 1996. Among other things, the Telecommunications Act of 1996 opens the local services market to competition and allows the Regional Bell Operating Companies to provide long-distance telecommunication services in and outside of their respective regions.

In August 1995, MCI made an initial investment of \$1 billion in The News Corporation Limited, as part of a strategy to form a joint venture to compete in various multimedia service markets.

For further information about MCI's business and the effects on it of regulation and competition in the United States, see the MCI 1995 10-K.

Regulation, competition and prices

Regulation

UK Regulation

The regime for the regulation of telecommunications activities in the United Kingdom is principally set out in the Telecommunications Act, which confers regulatory functions on the Secretary of State and the Director General. Under this Act, the Secretary of State and the Director General have a duty to exercise their functions to secure the provision, so far as reasonably practicable, throughout the United Kingdom of telecommunication services which satisfy all reasonable demands for them, including certain community services, and to secure the ability of licensed operators to finance the provision of those services. Subject to this duty, they are required, among other things, to promote the interests of consumers, purchasers and other users in respect of prices, variety and quality of telecommunication services and equipment, to maintain and promote effective competition between persons engaged in commercial activities in the UK telecommunications field and to promote efficiency and economy on the part of such persons.

With limited exceptions, a license under the Telecommunications Act is required for the running of a telecommunication system in the United Kingdom. Responsibility for licensing rests with the Secretary of State after consulting the Director General. The Director General has broad supervisory powers and duties under the Telecommunications Act and licenses issued under it. Accordingly, an important factor in the impact on BT of the UK regulatory system is how the Director General and the Secretary of State exercise their powers (many of which allow considerable discretion) and perform their duties.

The Director General is statutorily responsible for enforcing license conditions, and he may make orders requiring compliance, enforceable in the UK courts, which, if breached, could result in liability for damages to third parties. He also has broad discretionary powers (under the Telecommunications Act and in licenses) available to him and is responsible for monitoring the telecommunications market and investigating complaints about telecommunications-related matters.

In addition, the Director General may modify license conditions with the licensee's agreement. Alternatively, he may refer a matter concerning a license to the UK Monopolies and Mergers Commission (the "MMC"). If the MMC

recommends modifying conditions of the license concerned, the Director General is required to make the modifications which he considers necessary to remedy the adverse effects on the public interest identified by the MMC. In either case, the Telecommunications Act requires public consultation before license condition modifications can be made.

The Director General has concurrent jurisdiction with the Director General of the UK Office of Fair Trading ("OFT") in exercising certain functions under the UK Fair Trading Act 1973 and under the UK Competition Act 1980, but only in so far as they relate to telecommunications. See "General competition law".

The current Director General is Donald Cruickshank. He was appointed effective April 1, 1993 and his current appointment continues until March 31, 1998. The Director General is supported by the UK Office of Telecommunications ("OfTel"), which has a permanent staff of about 160.

The BT License

BT operates in the United Kingdom under a number of licenses granted under the Telecommunications Act, the most important of which is its public telecommunications operator license to operate its fixed-linked public telecommunication network (the "License"). The License is revocable by ten years' notice (given not before June 22, 1999) and may also be revoked at any time on various grounds, including non-compliance with an enforcement order.

The License contains terms and conditions designed principally to ensure the provision in the United Kingdom of widespread telecommunication services, to protect the interest of consumers and to encourage the development of effective competition in telecommunication services and equipment within the United Kingdom.

The Company is required by the License to provide, throughout nearly all of the United Kingdom, telecommunication services, including rural and international services, which satisfy all reasonable demands to the extent that it is practicable to provide such services (the "universal service obligation"). The Company must also provide certain public services and facilities.

The Company has to connect to its system on standard terms and conditions any other system run under a license which authorizes connection to the Company's system and which is composed of equipment which meets specified independent approval standards and to install separate wiring for its network and for customers' equipment in customers' premises, so as to enable private systems and equipment to be separate from the Company's system.

The Company must comply with a variety of fair trading obligations, such as a prohibition on showing undue preference or discrimination in the provision of certain services or unfairly favoring any part of its own business as against competitors; a prohibition on the unfair cross-subsidy of certain businesses of the Company, defined in the License; and a prohibition on the Company's ability to impose certain linked sales on customers and certain exclusive dealing arrangements on suppliers.

The License contains price control formulae, each of which, in the aggregate, requires the Company to reduce, or restrict the extent to which it can increase, the prices of many of its services. See "Prices". In addition, the License contains certain specific restrictions on the terms on which BT can trade. In particular, the Company is required to publish and adhere to standard tariffs and other terms for providing certain services, to make a uniform charge for the maintenance of exchange lines for premises served by a single line and, in general, to apply uniformly a published scale of charges for installing residential exchange lines on premises to be served by a single line.

The License also contains provisions enabling the Director General to monitor the Company's activities, including requirements for BT to supply him with information he requests and to maintain segregated accounting records for specified parts of its business. These parts, designated in the License for regulatory purposes, include the "systems business" (the activities of running the main UK network, including installation, maintenance and repair of the network and conveyance of telephone calls and other messages); the "supplemental services business" (generally value-added services and data services, including video-conferencing); and the "apparatus supply business" (broadly, the supply of customer premises equipment). In addition, the License requires the provision to the Director General of financial statements in respect of the systems business and apparatus supply business. See "Competition — Interconnection and accounting separation". In part, these financial statements are required to enable the Director General to satisfy himself as to compliance with the prohibition on unfair cross-subsidy discussed above. Where it appears to the Director General that an unfair cross-subsidy exists in relation to specified parts of its business, BT must take such steps as the Director General may direct for remedying the situation.

Fair trading in telecommunications

As part of the proposals for new controls on BT's prices for the period 1997 to 2001, the Director General has proposed a new License condition that would prohibit BT from doing anything which has the effect of preventing, restricting or distorting competition. See "Prices — Pricing of telecommunications services from 1997". This would replace a number of License conditions.

Interconnection under the License

The Company must, in accordance with the License, permit the interconnection to its system of certain other systems appropriately licensed for the provision of telecommunication services to the public. Interconnection agreements are, in the first instance, for negotiation between the companies concerned, but the Director General may determine unagreed terms and conditions, on the application of either party. In March 1993, BT's License was amended to require BT to publish, and make available to any interested party, interconnection agreements entered into from March 1993. BT must also publish details of any amendment to any interconnection agreement whenever the agreement was entered into. The License was also amended to allow the Director General to take into account discounts offered by BT to non-carrier customers when he determines interconnection charges to carriers. See "Competition — Interconnection charges".

In 1991, the interconnection condition in the License was amended to require interconnect call charges determined by the Director General to cover fully allocated costs of conveyance, including a full contribution to relevant overheads and a return on capital employed, judged by the Director General as reasonable for the systems business.

The License conditions relating to "access deficit contributions" (specific contributions in certain circumstances by other operators towards the losses incurred by BT in providing exchange lines) were removed in February 1996 concurrently with the removal of License restrictions on BT's ability to increase exchange line rental charges. See "Prices".

The Director General issued a statement in March 1994 describing his proposals for the future development of the rules governing interconnection and initial amendments were made to the License on March 31, 1995. See "Competition — Interconnection and accounting separation".

Competition and Service (Utilities) Act 1992

The UK Competition and Service (Utilities) Act 1992 amended the Telecommunications Act, in respect of residential customers and of other customers served by single exchange lines from the designated telecommunications operators. The Act applies to BT, but HM Government can only apply this Act to a competitor of BT if the competitor provides 25% or more of voice telephony services in its licensed area. Under the Act, the Director General acquired new powers concerning, among other things, service standards and the amount of compensation to be paid to individual customers if such standards are not met; overall performance standards; procedures for handling complaints; and criteria for charging deposits. The Director General's powers apply in relation to a specified range of services, including voice telephony, facsimile and directory information services. In particular, he can set enforceable performance standards after consultation with BT, but without the agreement of BT and without reference to the MMC. During 1995 the telecommunications industry voluntarily agreed to, and began publication of, comparable performance indicators. BT believes that it is unlikely that the Director General will now use his powers to set performance standards, although he retains the power to do so.

The Secretary of State is also empowered under this Act to make regulations giving the Director General power to resolve billing disputes.

As required by this Act, BT's complaints handling procedures were formally approved in December 1993, its deposit guidelines in March 1995 and a procedure for resolving disputes about deposits in July 1995. It is not expected that any other powers contained in this Act will be used in the near future. However, they will remain available and their effect cannot be assessed unless and until they are exercised from time to time. Although this Act contains powers which BT believes may, if implemented, have adverse effects on it, BT does not expect them to be material.

Universal service

The Director General is currently reviewing the universal service obligations ("USO") of UK telecommunications operators. Draft amendments to the licenses of such operators are expected to be published in November 1996, leading to implementation in July 1997. These license amendments are not expected to result in a significant extension to the Company's service obligations. The Director General is considering the establishment of a "Universal Service Fund".

This would collect contributions from all UK operators to enable costs incurred by the Company and other operators in implementing USO to be reimbursed. While the Company supports this proposal in principle, the net benefit or cost to the Company of such an arrangement is not expected to be material.

Radio spectrum licenses

The use of radio spectrum in the United Kingdom is regulated under the Wireless Telegraphy Acts of 1949 and 1967. BT's national and international telecommunication networks, including microwave and satellite links, are dependent on licenses under this Act. A comprehensive license covers all the Company's existing fixed terrestrial and satellite links and the use of maritime radio frequencies. In February 1996 HM Government indicated its willingness to grant to the Company a separate license under the Wireless Telegraphy Acts to authorise the use of spectrum for fixed telephony access in remote rural areas (covering about 4% of the UK population). Radiopaging services and Cellnet's cellular network are both licensed separately. Under this Act, wireless telegraphy licenses can be revoked or varied at any time, by the Secretary of State.

Historically, the Secretary of State has delegated exclusive management control of some blocks of radio spectrum to BT. However, in December 1991, HM Government stated that ultimately BT would lose management control of all its blocks with some specific exceptions. This is now happening at an increasing rate. Additionally, it is Government policy that well established networks should, where possible, move from radio to cable links.

In June 1996, HM Government published proposals on the future management of the radio spectrum. These included proposals for legislation to allow for charging for radio spectrum, including the use of auctions. BT expects that its operating expenses will increase if charges are introduced for use of the spectrum, and that the speed and flexibility with which it currently provides new or modified radio links, both within its network and direct to customers, will be reduced.

The EC Procurement Directive

In January 1993, UK regulations came into force implementing a European Council ("EC") directive concerning the procedures for the purchase of supplies and works by certain entities operating in the water, energy, transport and telecommunications sectors. A dispute arose between BT and HM Government concerning the UK implementation of an exemption within the Directive for telecommunication services.

BT instituted legal proceedings against HM Government challenging the legal validity of the UK regulations and at a hearing in June 1993, the UK High Court referred questions arising from the dispute to the European Court of Justice ("ECJ"). The case was heard before the ECJ on October 26, 1994. The ECJ's judgement was given on March 26, 1996. The Court in effect found that HM Government had misimplemented the directive by denying to BT the right to decide upon the applicability of the derogation contained in the directive. The derogation would allow BT to decide those of its activities to which the directive applies, and those where there is sufficient competition so that it should not apply.

The supplies and works directive was extended to cover the procurement of services in 1993 and was scheduled for implementation in the United Kingdom by July 1994. Publication of the implementing regulations has been delayed in the United Kingdom by HM Government, but a new draft has been prepared and implementation by HM Government is expected shortly, reflecting the ECJ's judgement mentioned above.

The EC leased lines directive

In accordance with an EC directive applying the principles of "Open Network Provision" to leased lines (private circuits), UK regulations implementing the directive came into force in October 1993. The directive requires the publication of information relating to the technical characteristics, supply and usage conditions of leased lines and the provision of a minimum set of leased lines offerings. The UK regulations impose a number of such obligations on BT, and to a lesser extent on Mercury Communications Limited ("Mercury"), which are not imposed on any of BT's other competitors in the supply of leased lines.

BT is particularly concerned about the further discriminatory application of an EC directive and has instituted legal proceedings against HM Government challenging the validity of the UK regulations, on the ground that they do not correctly implement the directive. A High Court hearing took place in July 1994 and the case was referred to the ECJ.

The case was heard before the ECJ on January 9, 1996. The Advocate General's opinion was delivered on May 23, 1996. He agreed with BT that, in effect, operators in the UK do not have special or exclusive rights. However, he also expressed the opinion that, where there were no entities with such rights, the member state must nevertheless impose the obligations of the directive on at least one undertaking so that the UK Government was entitled to implement this directive in relation to BT. Final judgement is expected by the end of 1996.

Overseas regulation

In developing its business internationally, BT must take account of the regulatory regimes in the countries in which it operates or wishes to operate. Generally, most countries' regimes are less liberal than those in the United Kingdom and North America. In North America, although the regulatory environment is generally liberal, there remain significant barriers to entry, including limitations on the level of stock which may be owned of record or voted by non-US citizens in US companies holding common carrier radio licenses (which are necessary for providing a full range of telecommunication services) to not more than 20% for direct holdings or 25% for indirect holdings. BT is active in pressing for liberalization of markets around the world to enable it to provide services to customers on a global basis.

BT has authorisations, either in its own right or through subsidiaries or joint venture companies to provide services on a resale basis in a number of overseas countries, including the US. The European Commission is pursuing a policy of progressive liberalization and harmonization. By January 1, 1998 the provision of infrastructure and the provision of all telecommunication services will be liberalized in the European Union ("EU"), apart from some derogations for the less developed member states. At the same time, new rules will be in place in respect of regulatory issues, including interconnections, universal service, transparent accounting and licensing. Draft directives are being considered on these issues and are expected to be adopted by the end of 1996. The directives, when adopted, may affect aspects of telecommunication regulation in the UK, but the likely effect cannot yet be assessed.

Investigations by the Director General

The Director General has requested that BT provide certain information relating to allegations of anti-competitive prices in the United Kingdom in relation to part of BT's data services. Information has been supplied by BT in relation to these allegations and BT has also been subject to a financial audit of the relevant businesses by external auditors, who were not the Company's auditors, commissioned by him. BT responded to the auditors' report and after considering the report and BT's response, the Director General said that the report did not enable him to form a judgement on the merits of the complaints which had prompted the investigation, and that it was necessary to carry out further investigation, on the same terms of reference, for fiscal 1994 and fiscal 1995. The auditors reported to the Director General in September 1995, following their further investigations. The Director General subsequently concluded that some parts of the managed network services business were being unfairly cross-subsidized. A direction was issued by the Director General on February 7, 1996 requiring BT to submit detailed compliance plans and regular financial reports designed to ensure that the cross-subsidy, identified by the Director General, ceased and was not repeated.

In March 1994, the Director General published the results of his inquiry into the provision of directory information services. They contained a number of proposals, including: a code of practice on the provision of directory information; new access options for public telecommunications operators for the provision of printed directories; examination of BT's charges in relation to directory information services; and working towards separate and transparent accounting in the same timescale as the rest of the work on interconnection and accounting separation. A proposal for a License modification may follow a further consultation by the Director General into measures to promote further competition in this area, including the establishment of a competing parallel national database operation. BT does not expect the effect of any of these proposals will have a material impact on BT's business as a whole.

Following an investigation in 1991, the Director General formed the view that an unfair cross-subsidy existed in relation to BT's apparatus supply business and issued a direction stipulating measures to be taken to remedy the situation. These included the production of a five-year budget showing how the apparatus supply business will progress to a position of satisfactory performance where any such cross-subsidy is eliminated. Quarterly accounts showing the performance of the apparatus supply business are also being provided as required under the direction. The Director General announced on June 29, 1995 that BT's forecast performance for fiscal 1997 was not satisfactory. A revised budget has been submitted which shows achievement of the required rate of return by the end of fiscal 1997. This is currently the subject of discussions with the Director General.

The Director General has investigated a complaint from some equipment suppliers about BT's activities in the telephone equipment market. The complainants claim that BT is, among other things, acting anti-competitively in the market for the provision of customer premises equipment. On September 22, 1995, the Director General issued a direction under BT's License, requiring BT to achieve specified rates of return in relation to certain product groups including telephone instruments, facsimile machines and telephone answering machines and the supply of these through BT's own and other retail outlets. The direction also requires the production of regular audited financial statements for those activities. BT has argued that some aspects of the direction are impracticable on the grounds that

specified rates of return for certain product groups cannot be achieved in the timescale required. The Director General has accepted BT's arguments and is currently amending the direction to respond to BT's concerns.

In his statement "Pricing of Telecommunications Services from 1997", the Director General said that he was concerned about the level of payments made by the Company to Vodafone and Cellnet for having calls terminated on their networks and, in his opinion, the consequent high prices for calls from the Company's fixed network customers to mobile customers of Vodafone and Cellnet. See "Prices — Pricing of telecommunications services from 1997". Although these payments had been reduced following the conclusion of new interconnection agreements between the Company and the two cellular operators, the Director General considered that they might still be too high in relation to cost, and is investigating further the level of charges in the new interconnection agreements and the Company's retail prices for these calls. The outcome of the investigation is awaited.

General competition law

In addition to regulation relating to BT or to the telecommunications industry in general, BT is subject to competition law of general application.

In March 1995, the OFT announced that it had decided to refer the supply of classified directory advertising services to the MMC for a monopoly investigation. The report was published on March 21, 1996. The MMC found that Yellow Pages ("YP") enjoyed a monopoly of classified directory advertising services in the United Kingdom and that it acted against the public interest in its pricing and publication of local directories. The MMC recommended establishment of YP as a BT subsidiary, arm's length dealings between BT and YP, an advertisement price cap (RPI minus 2) and a ban on YP covering any area with more than one printed consumer classified directory. The Department of Trade and Industry ("DTI") accepted all these recommendations except the first, which it considered unnecessary at present, given the MMC finding that existing arrangements conferred no significant benefits on YP. Discussions are continuing with the DTI regarding undertakings by BT to give effect to the MMC recommendations. Compliance with the recommendations will not have a material impact on BT's business as a whole.

Under its powers to investigate potential infringements of the EU's competition rules, the European Commission is examining the arrangements of operators within the EU governing prices and accounting rates for international telephone calls. BT has responded to a fact-finding letter from the European Commission on this subject. The Commission's investigations are continuing, but BT does not expect the eventual outcome to have a material impact on BT's business as a whole.

Competition

Since 1981, HM Government has followed a policy of seeking to introduce competition into the building and operation of public telecommunication networks in the United Kingdom, the provision of services over those networks, and the supply of equipment for connection to those networks. Entry to the market for the supply of telecommunications equipment is unrestricted and the supply of equipment to customers has become highly competitive.

From the time Mercury, a subsidiary of Cable and Wireless plc, commenced services, BT has faced direct competition in the provision of switched voice telephony and data services, particularly in serving business customers. The duopoly policy in place from 1983 until 1991 allowed only BT and Mercury to provide national fixed-link telecommunication services to the public. Since the review of that policy in 1991, HM Government has followed a policy of not restricting entry into the market for UK services and networks. See "Market entry".

Mercury launched its competing switched telephone service in 1986, giving increasing numbers of customers in the United Kingdom a choice of telephone companies for national and international calls and, to a lesser extent, local calls. Large users are often served by direct Mercury lines, whereas smaller businesses and residential users typically access the Mercury network indirectly via BT's network. Mercury competes particularly in the provision to call-intensive customers of international and long-distance calls, the most profitable parts of the UK telecommunications market. Certain market share information relating to BT and its competitors is included in "Item 9 — Management's Discussion and Analysis — Introduction — Competition".

The use of UK private circuits and exchange lines provided by any public telecommunications operator, including BT and Mercury, is unrestricted. The growth of international simple resale described in "Regulation — Overseas regulation" has resulted in some diversion of demand and revenues from BT's public switched network.

Market entry

In 1991, HM Government stated that it would consider applications from any number of applicants for licenses to offer public fixed-link UK local and long-distance telecommunication services, in accordance with the policy it outlined, with a general presumption in favor of applications being granted. It has also agreed to allow cable television companies to provide local fixed-link services, as described in "Cable television" and "Mobile services".

The provision of international simple resale is allowed between the United Kingdom and those countries where the regulatory regime has been designated by HM Government as equivalent to that in the United Kingdom. Countries designated to date are Australia, Canada, Finland, New Zealand, Sweden and the United States. In June 1996 HM Government announced that the BT/Mercury monopoly of international facilities would end this year, and that applications would be invited for licenses to provide international services using the operators' own facilities on all international routes. The Company would expect to see some consequential loss of market share as licenses are granted and operators commence operations.

Since 1991 over 150 new telecommunications licenses have been granted. The licenses cover a variety of activities, including local, long-distance and international telephony and international simple resale. Licenses granted in some cases allow licensees to offer a full range of services in the United Kingdom. None of the new or draft licenses has the same universal service obligation or fair trading conditions as the BT License and, even where the licensee is, or is to be, a public telecommunications operator, the regulation of the licensee's activities is limited until the licensee achieves a 25% market share.

AT&T Corporation ("AT&T") has been granted a public telecommunications operator license permitting the provision of UK switched voice and data services, private line services and international simple resale services. As both the US and UK governments now authorize international simple resale between the two countries, AT&T is able to provide an international simple resale service between the United States and the United Kingdom.

Until such time as the new licensees have passed their start-up phases, it is difficult for BT to predict the effect on its business. However, many of the licensees are large companies with substantial financial resources (and in the case of AT&T and Sprint, significant telecommunications experience), and they propose to operate in many of BT's key markets. The likely effect on BT of the successful implementation of their plans is expected to be a reduction in BT's market share, with consequential effects on revenues, offset to some extent by income from payments made by newly-licensed operators to interconnect with the BT network.

Service providers

In June 1996 the Director General published a statement containing proposals to change the regulations governing the supply by BT of service to those who use it as an input to their own enhanced services. It also addresses certain anomalies in the regulatory accounting arrangements for enhanced services within BT. The proposals involve giving BT limited pricing flexibility in its supply of service to independent service providers, recategorizing certain services as within the systems business and requiring certain network services to be provided separately. BT is at this stage unable fully to assess the likely effect of the changes until the Director General's proposals have been brought into effect and the market for service providers has developed sufficiently but, from the information available at present, BT believes that they are unlikely to be material.

Cable television

HM Government policy restricts BT from competing in the conveyance and provision of cable television services over its nationwide public network. The Company is prevented by the License from conveying television programs for simultaneous reception in more than one home, although conveyance to business premises is permitted. HM Government does not intend to remove this restriction before 2001, although the policy may be reviewed in 1998.

However, even if the License restriction is lifted there is a further constraint in that the policy of HM Government is, for the foreseeable future, to permit only one cable television operator to provide services in each geographical (franchise) area providing, in effect, a local cable television monopoly. HM Government has given no indication when this restriction is likely to be lifted, but has said that national public telecommunications operators, including the Company, will not be allowed to provide television delivery services nationally until 2001 at the earliest. This effectively prevents the Company from providing a national integrated network for delivery of both television and other telecommunication services over the same network. Cable television operators are also allowed to link adjacent franchises to provide telecommunication services over a wider area, and many have been granted licenses to run linking circuits between non-adjacent franchises.

US and Canadian telephone and cable television companies, with significant telecommunications experience and financial resources, are substantial investors in the majority of the UK broadband cable television operators. Over 130 cable television franchises have been awarded, which cover more than 70% of the UK population. Cable television operators are allowed to offer voice telephony and other telecommunication services on an integrated basis with their entertainment services, independently of the Company and other public telecommunications operators. Rate of growth is rapid: in April 1995, 872,000 cable telephony lines had been installed in 45 franchises. By April 1996, there were approximately 1,622,000 lines in 96 franchises.

The Company believes that the restrictions described above give a competitive advantage to cable television operators, the effects of which will grow in significance as franchises are developed and telecommunication services are introduced in larger areas. The growth in the number of cable telephony lines is expected to have an increasingly adverse effect on BT's share of the UK residential market.

Multimedia services

The Company is authorized to provide "on-demand" services where videos, television programs, and interactive multimedia services are sent to individual customers on request. A market trial of such a service commenced in 1995. See "Network modernization and capital expenditure — Research and development". The Director General has announced that he would look closely at any video-on-demand service offered by BT or others to make sure that the terms on which it is made available are fully consistent with UK policy on the competitive provision of telecommunications.

Mobile services

HM Government policy places certain restrictions on BT competing in the provision of mobile telecommunication services in the United Kingdom. HM Government has sometimes licensed existing participants in the UK telecommunications market and, in other cases, has expressly excluded existing licensees from participating in new services.

Although BT has a majority share in Cellnet and resells cellular services through its mobile communications unit, the Company itself is prohibited from providing mobile services under the License and was excluded from participating in the consortia licensed in 1991 by HM Government to operate PCNs. PCNs compete with existing mobile networks (using different radio frequencies), and also with fixed networks (including BT's local network).

HM Government has also licensed the two cellular telephone operators, Vodafone and Cellnet, and the two new PCN operators to provide fixed-link services in addition to their mobile operations, while continuing to exclude the Company and other national fixed-link operators from providing mobile services. BT is allowed to provide radiopaging services, but under a separate license, vested in the Company.

Interconnection charges

The Company operates under interconnection agreements with Mercury and a number of other licensed operators, including cellular, PCN, international simple resale and cable television operators, and is in negotiation with other licensed operators. Where BT and another operator cannot agree on charges or other terms to be included in the interconnection agreement, either party may refer the issue to the Director General for determination.

In June 1992, because they could not agree on appropriate revisions to their existing interconnection agreement, BT and Mercury jointly asked the Director General to review the terms of that agreement related to charging and access deficit contributions. In December 1993, under provisions in the BT-Mercury interconnection agreement, the Director General made a determination of the charges that Mercury will pay BT in respect of interconnection, including the maximum waiver available of Mercury's contributions to BT's access deficit. This determination was incorporated into a new agreement between the parties in November 1994. Mercury has instituted proceedings in the UK courts seeking a declaration that the correct interpretation of the License is in effect that the Director General should in future use an incremental costs, as opposed to a fully allocated costs, approach to setting interconnection prices. BT and the Director General both sought to have the proceedings dismissed. On February 9, 1995, the House of Lords decided that the proceedings may go forward in the UK High Court. This has not yet happened.

Interconnection and accounting separation

In June 1993, the Director General published a consultative document on interconnection and accounting separation. In the document, the Director General proposed that, in order to facilitate the calculation of interconnection charges, BT should publish new separate audited financial statements for accounting activities within its existing corporate

structure. Following public consultation on these proposals, the Director General published a statement in March 1994 outlining a three-stage implementation of his proposals.

The first stage involved BT implementing a standard method of calculating interconnection charges for all operators connected to BT's network, based on the Mercury determination in December 1993 described above.

The second stage involved the implementation of the interconnection and accounting separation "ICAS" proposals which were brought into effect as a consequence of BT's consent to the ICAS license modifications on March 31, 1995. The modifications provide for the Director General to determine standard charges for more than 70 standard interconnect services, and the reinforcing of the principle of no undue discrimination by BT amongst operators or between BT's retail operations and other operators with respect to both price and quality of service. These modifications also require BT to produce published and audited financial statements for the businesses and activities of a set of regulatory "businesses", in order to support the linkage of costs with interconnect prices and with a view to providing demonstrable evidence that BT is neither behaving in a discriminatory fashion nor unfairly subsidising its activities.

The regulatory "businesses" for which separated accounts are currently produced are: access; apparatus supply; network; retail systems; supplemental services; and residual. No organisational separation was required by the ICAS amendments. Fiscal 1995 financial statements for the businesses and activities were published on a historic cost basis on September 30, 1995, and on a current cost basis on November 30, 1995. Interim statements for the first six months of fiscal 1996 were published on January 31, 1996. BT has also published the accounting documents associated with the ICAS requirements. Financial statements for the businesses and activities for fiscal 1996 are to be published by July 31, 1996.

The third stage is currently subject to consultation. The Director General's current proposals include a change to a system of network price controls to replace the annual determination of interconnect charges by him. He also proposes changing the cost base of interconnection charges to long run incremental costs plus a mark-up instead of fully allocated costs. The Director General's aim is to implement this stage concurrently with changes to retail price control scheduled for 1997. See "Prices — Pricing of telecommunications services from 1997".

Equal access

Equal access would allow customers to choose between long-distance and international operators with equal ease. The Director General has power to determine that equal access be provided from BT's network subject to a cost-benefit study indicating that the gains to customers outweigh the costs likely to be incurred and if, in his opinion, sufficient arrangements have been made in relation to the Company's prices to achieve fair compensation. In August 1995 the Director General published a cost-benefit analysis which indicated that the costs of introducing equal access outweighed the benefits. Following a public consultation on the cost-benefit analysis, the Director General announced in April 1996 that he did not currently intend to instruct BT to implement equal access.

Number portability

Number portability enables customers to retain their numbers when changing the operator providing their telephone service. Subject to certain specified criteria being met, the Director General has the power to direct BT to provide number portability within specified geographical areas. In January 1994, the Director General announced that cost-benefit analysis, one of the criteria, supported the case for the introduction of number portability.

The Director General asked an industry-wide forum to co-ordinate technical work and draw up a timetable for discussion and implementation, with the objective of having an interim solution by the end of 1994, and a longer term solution by the end of 1995. This forum reported in August 1994, following which the Director General issued directions to BT requiring the provision of portability between BT and cable operators in nine areas with effect from October 7, 1994. Although BT complied with these directions, portability was not implemented as a result of them because agreement could not be reached on the charges for its provision.

The Director General concluded that his existing powers under the License were insufficient to bring about the early introduction of portability. He therefore proposed an amendment to the License which would permit him to determine how the costs of providing portability should be borne and would enable him to extend portability to customers moving to a different address. He had expressed the view that a significant proportion of the ongoing costs of providing portability should be borne by BT. On March 31, 1995, the Board of Directors decided not to consent to the Director General's proposed amendment, and the Director General subsequently referred the issue of charges for number portability to the MMC. The MMC's report was published in December 1995. The MMC recommended methods of

allocating various defined categories of costs of providing number portability, without discretions for the Director General to allocate these costs, but with discretions for him to determine into which of these categories other costs, not foreseen at the time of the MMC report, should fall. The recommendations have the effect of distributing the costs between BT and other operators approximately in the proportion of two thirds to one third, respectively, over the period fiscal 1997 to fiscal 2000. The Director General subsequently published a draft License amendment, which reflected the MMC's recommendations. Following a period of statutory consultations, this amendment is due to be incorporated in BT's License, and a similar amendment to be incorporated in the licenses of other operators is expected later in the year. The Director General has also announced his intention of extending portability from geographic numbers to non-geographic and mobile numbers.

When implemented, number portability will make it easier for BT's customers to switch to an operator other than BT and is thus likely to lead to loss of revenues. One of BT's competitors introduced number portability for new customers in May 1996.

Prices

The Company is subject to controls over baskets of retail prices which have the effect within each basket of requiring it to reduce, or limiting the extent to which it can increase, the aggregate of the prices of the services within that basket. The services subject to these price controls account for the majority of the Company's revenues. However, BT is not prevented from benefiting from improvements in efficiency by any limitation to a specific rate of return on capital nor is it generally required to obtain the prior approval of any regulatory authority for specific retail price changes. Since being imposed under the License in 1984, the price controls have been periodically tightened over the years by lowering the percentage amount of any permitted increases, by imposing specific limits in respect of particular services and by expanding the range of services covered by the controls.

These price controls, which are designed to protect the customers for the services covered, generally allow room for flexibility as to individual price changes by the Company within the overall limit, and limits on individual services, set by the controls, subject to the pressures of competition. No competitor, including Mercury, is subject to price controls.

BT is subject to two basic sets of price controls, one on public switched telephone services, essentially call charges and exchange line rentals, and one on private circuits. Each price control is based on a formula calculated by reference to the UK Retail Price Index ("RPI"). The weighted average increase in prices charged for the services covered by the controls, in each twelve-month period beginning August 1, cannot exceed a fixed percentage below the change in RPI (referred to as "RPI minus" the fixed percentage) for the twelve months to the preceding June 30. If the RPI increases by less than the fixed percentage, or falls, the Company must lower the weighted average prices for those services accordingly. In calculating the increase or reduction to these prices, each item is weighted in proportion to the contribution it made to the Company's operating revenues from services covered by the respective price controls in the previous fiscal year. Any permitted increase forgone (or excessive reduction made) in one year may generally be carried forward for up to two years. The Company is permitted to use any such increase (or reduction) when establishing its prices in future years, but may choose not to do so. In addition, there are price caps on each individual price and constraints on the timing of price changes. Following a license modification in September 1994, price changes are now made so that RPI minus 7.5 is achieved on a weighted average on or before November 1 each year.

Public switched telephone services

The Company estimates that the public switched telephone services formula in effect during fiscal 1996, which covered exchange line rentals and local, long-distance and international calls made by customers in the United Kingdom, applied to approximately 52% of BT's total operating revenues.

The current price control formula for these services, which applies from August 1993 through July 1997, is RPI minus 7.5. The formula was tightened from the RPI minus 6.25 that applied during the years beginning August 1, 1991 and 1992.

The price control formula for public switched telephone services and the Company's performance against the formula since August 1, 1991 have been as follows:

Price control formula	Year commencing August 1,					
	1991	1992	1993	1994	1995	1996
RPI movement for the relevant period (a)	5.84%	3.88%	1.22%	2.62%	3.52%	(b)
RPI formula in effect	(6.25)	(6.25)	(7.50)	(7.50)	(7.50)	(7.50%)
Required reduction in prices (c)	(0.23)	(0.95) (d)	(6.94)	(4.86)	(1.38)	(b)
Reduction in prices overall	(0.73)	(0.47)	(6.95)	(7.35)	(1.82) (e)	(f)